DIRECTOR-GENERAL OF INLAND REVENUE

v.

PHALTAN SUGAR WORKS LTD.

FEDERAL COURT, KUALA LUMPUR
RAJA AZLAN SHAH CJ (MALAYA)
WAN SULEIMAN FJ
EUSOFFE ABDOOLCADER J
[CIVIL APPEAL NO. 39 OF 1981]
25 SEPTEMBER 1982

REVENUE LAW: *Income Tax - Foreign company registered locally acquired shares in consideration of providing technical know-how, service and investment - Whether consideration chargeable to income tax - Appeal to Special Commissioners of Income Tax.*

The respondent company was incorporated in India and was engaged in the growing of sugar cane and the manufacture of sugar in India since 1933 and thus acquired considerable technical know-how, experience, information and skill in this field. On 24 November 1972 the Negeri Sembilan Development Corporation entered into three agreements namely technical know-how, service and investment with the respondent for the purpose of setting up a joint venture. The Corporation incorporated a private ltd. co. (syarikat) in 1972 for the purpose of using the said technical know-how and for the purpose of setting up the sugar cane plantation factory. The Syarikat adopted and ratified all the three agreements entered into between the respondent and Negeri Sembilan Development Corporation and commenced production in 1975. Meanwhile the respondent was registered as a foreign company in Malaysia in 1973.

In consideration for providing the three services by 15 October 1975 the respondent held RM3,400,000 worth of shares and the Corporation RM5,000,000 worth of shares in the syarikat. On the consideration received under services agreement, the respondent was assessed to income tax and development tax for the years of assessment 1974, 1975 and 1976. The respondent appealed to the Special Commissioners of Income Tax against the notice of assessment issued by the appellant. The principal question raised were:

(1) whether the consideration received under the know-how agreement is chargeable to income tax.

(2) whether the consideration under the technical services agreement constitutes income in respect of royalty.

The Special Commissioners decided that (1) is chargeable to income tax and (2) is not royalty income. The respondent appealed against decision (1) and whereas the appellant appealed against (2) to the High Court. The learned Judge allowed the appeal by the respondent and dismissed the cross-appeal by the appellant. This appeal by the appellant is against the whole of the decision of the learned Judge.

Held:

[1] The respondent conceded that the receipts under the know-how agreement are revenue receipts and not capital receipts and therefore chargeable to income tax.

[2] Payments under the technical services agreement are royalty income and not exempted from taxation in Malaysia.

[Appeal allowed with costs.]

Cases referred to:
Evans Medical Supplies v. Moriarty 37 TC 540
Jeffrey v. Rolls-Roys Ltd. [1962] 40 TC 443
Commissioners of Inland Revenue v. English Electric Co. Ltd. [1964] 41 TC 526
American Leaf Blending Co. Sdn. Bhd. v. Director-General of Inland Revenue [1979] 1 MLJ 2

Legislation referred to:
Double Taxation Relief Order 1976 [Ind], arts. 3(2), 5(2), 7(1), 13(2), (5)(b), 22(1)
Double Taxation Relief Order 1976 [NZ], arts. 2(1)(k), 10(3)
Double Taxation Relief Order 1968 [Sing], art. VIII(2), (3)
Income Tax Act 1967, ss. 2, 4

For the appellant - Jamil Hajar b. Abdul Muttalib
For the respondent - James Puthucheary; M/s. Skrine & Co.

JUDGMENT

Wan Suleiman FJ:

The Phaltan Sugar Works Ltd. (the respondent company) appealed to the Special Commissioners of Income Tax against the notice of assessment issued against it by the Director-General of Inland Revenue. The principal question the Special Commissioners had to determine was:

(i) whether the consideration under the know-how agreement constitutes income in respect of royalty under the Income Tax Act under the India Order and is therefore chargeable to income tax, or whether it is capital receipt and therefore not chargeable to income tax, and

(ii) whether the consideration under the technical services agreement constitutes income in respect of royalty.

The facts which the Special Commissioners found proved or admitted are adequately summarised in the judgment of the High Court in dealing with the appeal and cross-appeal from their decision and are as follows:

The appellant company was incorporated in India on 8 March 1933 with its registered office situated in Bombay. Since then it has engaged in the growing of sugar-cane and the manufacture of sugar in India thereby acquiring considerable technical know-how, experience, information and skill in this field. On 24 November 1972 the Negeri Sembilan Development Corporation (hereinafter referred to as "the Corporation") entered into three agreements with the appellant for the purpose of setting up a joint venture namely -

(i) know-how agreement;

(ii) services agreement; and

(iii) investment agreement.

Under the know-how agreement the appellant sold to the Corporation for use in Malaysia all the processes, formulae, knowledge and technical know-how which had been developed by the appellant for the establishment, organisation, erection and installation of a sugar-cane plantation and sugar factory and the production of sugar and allied products. The Corporation was to make use of all these processes as it might think fit and to dispose of the same to any person for the purpose of their application within Malaysia subject to the consent of the appellant which consent was not to be unreasonably withheld. The Corporation agreed not to part with those processes and the technical know-how within

Malaysia without the consent of the appellant; also that the Corporation should not supply, sell, dispose or otherwise dispose of the technical information provided by the appellant to any person outside Malaysia and the appellant was not to supply, sell or disclose information on the know-how to any person within Malaysia other than the Corporation.

In accordance with the know-how agreement the Corporation incorporated a private limited company in Negeri Sembilan known as Syarikat Gula Negeri Sembilan (hereinafter referred to as "the Syarikat") for the purpose of using the said technical know-how and for the purpose of setting up the sugar-cane plantation and factory. The Syarikat was duly incorporated on 16 November 1972 and it adopted and ratified all the three agreements which the appellant had entered into with the Corporation. In due course the appellant delivered to the Corporation the technical material relating to the know-how and also provided skilled personnel under the services agreement to supervise and implement the know-how agreement and the services agreement.

The consideration for the sale of the use of the know-how was by allotment of 1,500,000 shares in the Syarikat to the appellant which was allotted on various dates with a face value of RM1,500,000. The allotment of 600,000 shares on 27 September 1973 was the subject - matter of the appeal which was heard by the Special Commissioners of Income Tax in respect of a notice of assessment for the year of assessment 1974 which was issued to the appellant. This allotment of shares was recorded by the appellant as a capital receipt in the appellant's balance sheet.

Under the services agreement the appellant provided agricultural, commercial, technological, scientific and administrative assistance and expertise to the Syarikat for the purpose of setting up the sugar-cane plantation and factory. The consideration for the services under this agreement was a lump sum of RM600,000 which was paid by instalments. This sum of RM600,000 was recorded in the accounts of the appellant as revenue receipt.

The appellant company was registered as a foreign company in Malaysia on 5 July 1973 with its registered office in Seremban.

The appellant was assessed to income tax and development tax on the consideration received under the services agreement in respect of which notices of assessment were issued for the years of assessment 1974, 1975 and 1976.

Under the investment agreement the appellant agreed to take up additional shares in the Syarikat at the face value of RM2,500,000 which were allotted to it on 13 October 1975 and the appellant in turn imported machinery from India for the Syarikat.

The Syarikat commenced production on 28 February 1975 and as at 15 October 1975 the appellant held RM3,400,000 worth of shares and the Corporation RM5,000,000 worth of shares in the Syarikat.

The Special Commissioners decided that:

(a) the consideration under the know-how agreement constituted **royalty income** under the India Order and is therefore chargeable to income tax on royalty at the rate of 15 per cent of gross value pursuant to Part II of Schedule One of the Income Tax Act, and confirmed this aspect of the notice of assessment. Against this part of the decision the respondent company appealed to the High Court;

(b) the consideration under the technical services agreement constituted **business income** attributable to a permanent establishment of the respondent company in Malaysia pursuant to the India Order and is therefore not royalty income under the said Order,

and ordered the amendment of this aspect of the notice of assessment to give effect to their decision. Revenue cross-appealed to the High Court against this second part of their decision.

After considering a number of authorities cited the learned Judge held that the consideration received by the respondent company under the know-how agreement was a **capital** receipt, not a revenue receipt, and allowed the appeal. However, his Lordship agreed with the Special Commissioners that the RM600,000 paid to the respondent company under the service agreement was business income under the India Order, and not royalty, and therefore dismissed the cross-appeal by Revenue.

Revenue has appealed against the whole of this decision.

On the first issue it was urged upon us that the Special Commissioners were correct in holding that the consideration received under the know-how agreement constituted royalty income, and not capital income as the learned Judge held it to be.

It is clear from his judgment that he relied on the decision in *Evans Medical Supplies v. Moriarty* 37 TC 540.

There the appellant company, which manufactured pharmaceutical products and had a world-wide trade, carried on business in Burma through an agency. In 1953 the Burmese Government wished itself to establish an industry there for the production of pharmaceutical and other products, and the company secured a contract, dated 20 October 1953, from the Burmese Government to assist in setting up this industry. The company undertook to disclose secret processes to the Burmese Government and to provide other information in consideration of the payment of a "capital sum of £100,000". The company also undertook to provide certain services and to manage the proposed factory in return for an annual fee, which was admitted to be subject to tax. No similar agreement had been entered into by the company with any other foreign Government or any other party.

The profits of the company's trade as wholesale druggists were assessed to income tax under Case I of Schedule D for the year 1954-55 on the footing that the sum of £100,000 should be included as a trading receipt. On appeal to the Special Commissioners the company contended that the sum of £100,000 was a capital sum received either for the sale of fixed capital or for the granting to the Burmese Government of an exclusive licence, and that in any event it did not arise in the course of a trade. The Crown contended, *inter alia*, that on a true construction of the agreement the sum in question was, like the annual fee admitted to be subject to tax, received by the company for providing services in the course of a trade. The Special Commissioners held that the agreement should be read as a whole as one for the provision of services, and that the sum of £100,000 had been properly included in computing the company's profits for income tax purposes.

The Chancery Division held that the sum in question was a capital payment.

The Court of Appeal held unanimously (1) that there was evidence to support the Special Commissioners' finding that the sum of £100,000 arose to the company as a receipt of its trade; but (2) that the sum in question, to the extent that it was attributable to the disclosure of secret processes, was a capital receipt. The Court ordered the case to be remitted to the Commissioners to determine the part so attributable.

The House of Lords, dismissing the Crown's appeal and allowing the company's cross-appeal, restored the order of the Chancery Division.

At p. 579, Lord Simonds said:

> It was perhaps a doubt in the mind of the Inspector of Taxes whether this sum could be regarded as an income receipt of the company's trade as 'wholesale druggists' which led to the alternative suggestion of a new trade. But however that may be, the evidence - I am now looking at the question propounded in the Case - is overwhelming that the company parted with a capital asset and received for it a capital sum. Of paramount, if not decisive, importance is the agreement itself. I need not repeat its recitals or its terms. The company parted with something for which the Government was prepared to pay no less than £100,000. Its possession had secured for the company a substantial share of the Burmese market: its loss will mean, in the words of the Commissioners, that "the company's Burmese agency will become progressively less important", or, in other words, that the company has parted with an asset which was the source, or one of the sources, of its profits.

The above passage, submits Counsel for Revenue, is the corner stone of the decision.

In *Jeffrey v. Rolls-Roys Ltd.* [1962] 40 TC 443, the respondent company, during the manufacture of aero engines, engaged in metallurgical research and the development of engineering techniques. During the period 1946 to 1953 it entered into a number of agreements with foreign governments and companies under which it agreed to supply this know-how to construct certain engines which it had developed and license the other party to manufacture these engines.

The profits of the company's trade were assessed on the footing that the sum received under the various agreements were trading receipts.

The House of Lords held, distinguishing *Evans*' case *infra* that these receipts were on revenue account of the company's trade and fell to be included in the computation of its profits or gains. We need only refer to what Viscount Simonds said at pp. 490/491. Referring to the *Evans*' case, he said:

> The facts in the earlier case were complicated, but the inference was there drawn that the capital sum in question was paid for the communication of secret processes to the Burmese Government with a resulting total loss to the company of its Burmese trade ... In the circumstances of that case regard being had to the fact that the transaction was an isolated one of its kind, the conclusion was inevitable that the so called capital sum was a receipt of a capital nature ... The decision did not establish, or purport to establish, a principle that whatever, and however often, a company communicates what is called "know-how" to a third party and receives what is called a lump sum for it, the sum is for tax purposes a capital receipt.

Jeffrey's case was reaffirmed by the Lords in *Commissioners of Inland Revenue v. English Electric Co. Ltd.* [1964] 41 TC 526.

In view of Encik Puthucheary's conceding after considering authorities not cited in the Court below that the receipts under the know-how agreement are indeed revenue receipts and not capital receipts, we need not dwell upon this aspect of the appeal much longer except to affirm that Revenue was correct in maintaining that on the present particular set of facts *Evans*' case does not apply. Having made this concession however learned Counsel for the respondent went on to say that though it was a revenue receipt it fell into the sub-category of trading receipt, and that whether royalty is payable or not must depend on the definition of royalty in the Income Tax Act and the Double Taxation Relief (India) Order 1976.

We were invited to compare certain provisions of the Double Taxation Relief (Singapore) Order 1968, and the Double Taxation Relief (New Zealand) Order 1976.

Article VIII(2) & (3) of the Singapore Order, which defines "royalities" reads:

> 2. The term "royalities" as used in this Article means payments of any kind received as consideration for the use of, or the right to use, any copyright, patent, trademark, design or model, plan, secret formula or process or for the use of, or the right to use industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience, but does not include any royalty or other amount paid in respect of literary or artistic copyrights or of motion picture films or of tapes for television or broadcasting or of the operations of a mine, oil well, quarry or other place of extraction of natural resources or of timber or forest produce.
>
> 3. Sums derived by a resident of one of the Contracting States from sources within the other Contracting State from the alienation of any right or property from which royalties, as defined in para. 2 of this Article, are or may be derived, may be taxed in the Contracting State from which the sums are derived.

In the New Zealand Order, Article 10 deals with the subject of royalities.

Clause 3 thereof reads:

> In this Article, the term "royalties" means payments of any kind to the extent to which they are made as consideration for -
>
> (a) the use of or right to use any -
>
> (i) copyright, patent, design or model, plan, secret formula or process, trade mark or other like property or right; or
>
> (ii) industrial, commercial or scientific equipment; or
>
> (iii) motion picture films; or
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> (iv) films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting; or
>
> (b) the supply of -
>
> (i) scientific, technical, industrial or commercial knowledge or information; or
>
> (ii) any assistance which is given as a means of enabling the application or enjoyment of such knowledge or information; or ...

It was submitted that the "use and the right to use" should be distinguished from the "supply of the information". The India Order, argues Counsel is by comparison narrower. Article 13(5) reads:

> The term "royalties" as used in this Article means payment of any kind received as a consideration for the use or the right to use -
>
> (a) any patent, trademark, design or model, plan, secret formula or process;
>
> (b) industrial, commercial, or scientific equipment, or information concerning industrial, commercial or scientific experience;
>
> (c) any copyright of literary, artistic or scientific work, cinematograph films, or tapes for television or broadcasting,
>
> but does not include royalties or other amounts paid in respect of operation of mines or quarries or of the extraction or removal of natural resources,

and omits any reference to the "supply" (which Counsel equates to "alienation" in the Singapore Order). But we note that whilst Article 10(3)(a) of the New Zealand Order stops short at "the use of or the right to use industrial, commercial or scientific equipment", the India Order Article 13 Clause 5(b) reads,

"the use of or the right to use -

(b) industrial, commercial or scientific equipment, or **information concerning industrial, commercial or scientific experience**;

Such information is in other words information on "know-how".

It would appear to us therefore that there can be no difference between the expression "the supply of such information or knowledge" and "the use or right to use such information", so that this argument must fail.

Another difference we are told is to be found in Article 2 Clause 1(k) of the New Zealand Order which defines "industrial and commercial profits". There being no such definition in the India Order, then because of Article 3 Clause 2 of the Order, the meaning would have to be sought in "the laws of that Contracting State relating to the taxes which are the subject matter of this agreement," i.e. our Income Tax Act 1967, and in particular s. 4 of our Act.

We were told that the Privy Council decision in *American Leaf Blending Co. Sdn. Bhd. v. Director-General of Inland Revenue* [1979] 1 MLJ 1 at p. 2 is particularly relevant. There Lord Diplock in delivering the judgment of the Board said:

> If the words in the various paragraphs of s. 4 of the Malaysian Act are given their ordinary meaning - and their Lordships see no reason why they should not be - there is plainly room for overlapping between one paragraph and another. A company may carry on business as an investment or holding company deriving its gains or profits from dividends and interest from the securities it owns. The gains or profit from the business of a bank or moneylender are largely derived from interest received on money lent. A property company or an individual may be carrying on the business of letting premises for rents from which the gains or profits of that business are derived.
>
> That there is a potential overlapping between para. (a) and para. (c) and (d) is, in their Lordships' view, put beyond doubt by the provisions of s. 24. The general rule laid down in ss. 27 and 28 is that income other than income from a business does not become chargeable until it has actually been received. By s. 27(1) this is applied specifically to "rent". The purpose of s. 24 is to provide as an exception to the general rule that on computing chargeable income from a business book debts arising in the period of assessment shall be brought into account although not actually received. Sub-sections (4) and (5) apply this exception to dividends and interest on securities held by investment companies and interest receivable in the course of carrying on a business of lending money; while sub-section(1)(c) applies the same exception *inter alia* to debts arising "in respect of ... (c) the use or enjoyment of any property dealt with at any time in the course of carrying on a business."
>
> So it is clear that "rents", despite the fact that they are referred to in para. (4) and s. 4, may nevertheless constitute income from a source consisting of a business if they are receivable in the course of carrying on a business of putting the taxpayer's property to profitable use by letting it out for rent.

It follows, Counsel argues, that because of this overlapping business income under our Act is a total income from business activities, and would include rents and royalties, and what we would have to consider now in construing the India Order is business income (or profits) rather than royalties. He then referred to Article 7.1 of the India Order which reads as follows:

> The income or profit of an enterprise of one of the contracting states shall be taxable only in that contracting state, unless the enterprise carried on business in the other contracting state through a permanent establishment situated herein.

Pursuing this line of reasoning Encik Puthucheary goes on to say that whilst Article 13 (of the India Order) states that royalties may be taxed, it is Article 7 to which we should resort since royalty is part of business income. Since under the know-how agreement this RM600,000 is not derived from any permanent establishment in Malaysia, there being during the material period none here, it is not taxable in Malaysia.

At a later stage Encik Puthucheary conceded that, as the records show, there is a permanent establishment in Malaysia, but maintains that since the source of know-how and technical materials relating hereto is India, only the first limb of Article 7.1 would apply, so that royalty income is not taxable here.

It seems to us that Encik Puthucheary wishes to have his cake and to eat it at the same time. It is possible that just as in the *American Leaf Blending* case, the respondent here had been carrying on a business of putting the company's property i.e. know-how to profitable use by selling its know-how. But the fact remains that the company has a permanent establishment in Malaysia and Malaysian tax would be imposable on the income or profits of such establishment, and that would include the "royalty" income.

Whilst Encik Puthucheary says that there is no conflict between the definition of "royalty" in the Income Tax Act, and that in the India Order, he argues that the definition in the Act is wider. This we agree is correct, but this contributes nothing to his arguments.

The law applicable is the Income Tax Act 1967 and the India Order merely provides relief only from double taxation. We therefore hold that the finding of the Special Commissioners under this heading is correct.

The other head of appeal is against the learned Judge's decision in holding that (in this he agreed with the Special Commissioners) the consideration received by the respondent was business income attributable to a permanent establishment of the respondent in Malaysia under the India Order, not royalty under the Income Tax Act 1967. We note that the learned Judge gave no indication how he arrived at this result. Learned Counsel for Revenue repeats that here again both the Special Commissioners and the learned Judge had made the error of confusing the concept of the imposition of tax (which is governed by the Income Tax Act) and exemption from certain taxation otherwise payable thereunder as a consequence of the India Order.

Counsel for Revenue urges us to hold that what was paid under the latter agreement is also royalty of a category not exempted under Article 13.2 of the India Order.

This was precisely the argument taken before the Special Commissioners. In short what Encik Jamil is saying is that only the narrowed down definition of "royalty" under the India Order can under certain circumstances be exempted from taxation, which is supported, if support is indeed required, by Article 22.1 of the India Order. Under s. 2 of the Act "royalty" includes:

> (d) any other amounts paid in consideration of technical advice, assistance or services rendered in connection with technical management or administration of any scientific, industrial or commercial undertaking, venture, project or scheme.

We agree that payments under the technical services agreement are royalty income, and on the facts, of a category not exempted under the India Order from taxation in Malaysia.

The appeal is therefore allowed with costs here and below.

Also found at [1983] 1 CLJ 15